Tennessee Small Business Investment Company Credit Act
Frequently Asked Questions (FAQ)

SECTION 1: APPLICATION, ELIGIBILITY, AND LEGAL STRUCTURE OF TNINVESTCOS

2009 Public Chapter 610, Section 3(16), provides that "TNInvestco" means "a partnership, corporation, trust, or limited liability company, whether organized on a for-profit or not-for-profit basis that completes the application process … and that is certified by the Department of Economic and Community Development as meeting the established criteria."

Q 1.1 – Who is eligible to be certified as a TNInvestco?

Any partnership, corporation, trust or limited liability company may apply for certification as a TNInvestco by completing the following requirements by October 1, 2009. The Department of Economic and Community Development will review the application for certification and determine an entity's eligibility. Entities wishing to be certified as a TN Investco must:

- File an application with the Department of Economic and Community Development along with a nonrefundable application fee of $7,500 payable to the "State of Tennessee" at the time of filing the application.

- Submit as part of the application an audited balance sheet that contains an unqualified opinion of an independent certified public accountant issued within 60 days of the application date that states that the applicant has an equity capitalization of $500,000 or more in the form of unencumbered cash, marketable securities, or other liquid assets.

Q 1.2 – The eligibility criteria for receiving a tax credit allocation is more restricted than the criteria for certification as a TNInvestco. Will these criteria be rigidly enforced or will the Commissioners allow for flexible interpretations, especially related to the years of investment experience primarily in Tennessee businesses?

A TNInvestco will be awarded investment tax credits based on an evaluation of the entity's application and its ability to successfully fulfill the economic development goal of the program. The TNInvestco Act provides that:

- A successful applicant must have at least two investment managers with at least five years of investment experience.

- The entity must have been based, as defined by having a principal office, in Tennessee for at least five years or have at least five years of experience in investing in Tennessee domiciled companies.

The above criteria are designed to ensure that applicants for tax credit allocations have sufficient investment management experience and a previously established and longstanding commitment to business development activities in Tennessee. The TNInvestco Act allows for the Commissioner of Economic and Community Development and the Commissioner of Revenue to determine whether an applicant has met the spirit of the guidelines enacted. The criteria are not intended to impose technical barriers to funds that could best serve the economic development interests of the state.

Q 1.3 – Is the residency criteria intended to deter out-of-state participation?

No. The purpose of the residency criteria is to ensure that the management and/or controlling interests of a TNInvestco receiving a tax credit allocation have a previously established and longstanding commitment to business development activities in Tennessee.

Q 1.4 – Under what circumstances would the state consider two applications, both of which include a certain individual or entity, to be "independent" applications such that the awarding of tax credit allocations would not be considered two allocations?

The maximum allocation award that can go to any individual or entity is two allocations. No individual or entity may participate in more than one application asking for $40 million or two applications asking for $20 million each.

Q 1.5 – Must complete organizational documents be submitted with the application?

The applicant entity must provide the names of individuals and/or organizations that will own more than 5% of the shares in the entity; a description of the entity's organizational structure; its FEIN; the entity's equity capitalization on application date; an audited balance sheet; and a nonrefundable fee of $7,500.

Q 1.6 – 2009 PC 610, Section 6(b), provides that "[e]ach TN Investco shall submit irrevocable investment commitments from participating investors … not later than November 30, 2009." Does this application deadline apply to applications for investment tax credits?

On or before November 1, 2009, a maximum of six TNInvestcos will be notified that they have been awarded allocations of tax credits. TNInvestcos receiving such notification have until November 30, 2009, to obtain irrevocable commitments from participating insurance companies equal to the base investment amount ($14 million for each $20 million allocation). TNInvestcos that are unable to secure the required commitments by November 30, 2009, will be subject to a $50,000 penalty. In such case, an alternate TNInvestco will be notified on December 1, 2009, that it has been awarded an allocation and will have until December 31, 2009, to obtain the irrevocable commitments.

Q 1.7 – Is an entity that completes the application for certification as a TNInvestco guaranteed an award of investment tax credit allocations?

No. The awarding of investment tax credits shall be in the sole discretion of the Commissioner of Economic and Community Development and the Commissioner of Revenue and must be made in accordance with the guidelines set forth in the TNInvestco Act.

Q 1.8 – Will awards of investment tax credit allocations be made prior to the application deadline for certification as a TNInvestco?

No. The application deadline for certification as a TNInvestco is October 1, 2009. No awards of investment tax credit allocations will be made prior to that date.

Q 1.9 – What are the important dates associated with the TNInvestco program?

The most important dates are as follows:

- October 1, 2009: Deadline for submission of the TNInvestco application. The application and instructions are available at www.state.tn.us/ecd/tninvestco/documents.html
- October 2009: Application review and finalist interviews
- Around November 1, 2009: Announcement of the TNInvestcos chosen to receive investment tax credit allocations
- December 1, 2009: Announcement of any alternate TNInvestcos chosen to receive investment tax credit allocations (in the event an original finalist is unable to secure irrevocable commitments from participating investors)

- January 2010: Award of investment tax credit allocations to the qualified TNInvestcos

Q 1.10 – Is the application for certification as a TNInvestco a public record?

Part 1 of the application for certification as a TNInvestco is a public record open to inspection. However, Part 2 is confidential and not subject to a request for public inspection under Tenn. Code Ann. § 10-7-503 of the Tennessee Public Records Act.

Q 1.11 – 2009 PC 610, Section 6(c)(1)(A)(i), lists criteria on which application will be reviewed, specifically 5 years of investment experience for each of the investment managers. However, Part II.6 of the application document specifically asks for years of experience investing primarily in TN domiciled companies. May an applicant add a column to Part II.6 to highlight any relevant experience that does not involve investments in TN domiciled companies?

Yes.

SECTION 2: ACCESSING INVESTMENT CAPITAL FROM INSURANCE COMPANIES

Q 2.1 – Are participating insurance companies actually investors in a TNInvestco?

Yes. However, there is no requirement that a participating investor take an equity interest in the TNInvestco.

Q 2.2 – Must a participating investor's investment equal the amount of the tax credits awarded to the participating investor?

No. The amount of the tax credit is 100% of the amount *allocated to the participating investor* by the TNInvestco. The amount of the tax credit is not equal to 100% of the amount invested.

Q 2.3 – Are the tax credits subject to forfeiture or clawback based on the performance of the TNInvestco?

No. The participating investor's investment tax credit is earned and vested upon making its investment in the qualified TNInvestco. The subsequent performance of the TNInvestco has no bearing on the investor's entitlement to the tax credit.

Q 2.4 – May a Health Maintenance Organization invest in a TNInvestco as a participating investor and receive an allocation of investment tax credits?

A participating investor must be an insurance company that is required to pay the gross premiums tax pursuant to Tenn. Code Ann. § 56-4-205. Therefore, if an entity is subject to the gross premiums tax under any other section of the Tennessee Code, then it is not eligible to invest in a TNInvestco as a participating investor and cannot receive an allocation of investment tax credits.

SECTION 3: TAX ISSUES UNIQUE TO TNINVESTCOS

Q 3.1 – Does a TNInvestco incur a federal tax liability when it receives a tax credit allocation from the State of Tennessee?

The Internal Revenue Service is the sole arbiter with respect to federal tax matters. The state will support TNInvestcos seeking clarification from the IRS regarding the proper federal tax treatment of the credit allocation. The state recognizes that federal tax liabilities could reduce the effectiveness of this economic development initiative and will accordingly work with TNInvestcos to minimize any adverse federal tax implications.

SECTION 4: INVESTMENT STRATEGIES FOR TRANSFORMATIONAL OUTCOMES

Q 4.1 – What is a transformational economic development strategy?

The purpose of the TNInvestco Act is to encourage and support investments in qualified small businesses that have the potential to transform the State of Tennessee's economy.

Companies like FedEx and HCA were founded by entrepreneurs and eventually backed by venture capital investors. These companies have had a transformational impact on the state's economy through the jobs, wealth and tax revenues made possible, directly or indirectly, by the efforts of the entrepreneurs that turned vision into reality and the investors that fueled their ambition. The goal of this program is to create opportunities for such economic growth in Tennessee.

TNInvestcos that receive an allocation of tax credits must propose an investment strategy to make seed and early stage investments in Tennessee small businesses that could potentially transform the state's economy. It is the responsibility of the TNInvestco to communicate its strategy and explain how a successful implementation of its strategy will yield transformational outcomes.

Q 4.2 – The definition of seed or early stage investment allows for exceptions to the general guidelines provided. Is there additional guidance on how this important classification will be adjudicated?

2009 Public Chapter 610, Section (14), provides that "seed or early stage investment" means an investment in a company that has a product or service in testing or pilot production that may or may not be commercially available. The company may or may not be generating revenues and may have been in business less than three years at the time of investment.

It is the responsibility of the TNInvestco to demonstrate that a company in which it invests deserves classification as a seed or early stage investment (and thereby receives a 300% multiplier for purposes of meeting the pacing requirements outlined in Section 7 of the TNInvestco Act). Common sense guidelines should apply. For example, an investment in a small business created when an uncommercialized technology was spun out of a large company would most likely merit classification as a seed or early stage investment. In contrast, an investment in a small business created when an established business unit was spun out of a large company would most likely not count as a seed or early stage investment.

Q 4.3 – 2009 PC 610, Section 3 10(A)(iii), states that a TNInvestco may not invest in the following businesses: legal services; banking or lending; real estate development; insurance; oil and gas exploration; direct gambling activities; or professional services provided by accountants and doctors. What is the intent of these restrictions?

The restrictions on the types of investments a TNInvestco is permitted to make are intended to deter investment in businesses that typically have ready access to funding. The TNInvestco program is intended to have a transformational impact on the state's economy through the jobs, wealth, and tax revenues of the businesses that are created. Any specific questions regarding types of businesses that could or should be funded through the TNInvestco program should be addressed to the Department of Economic and Community Development.

SECTION 5: INVESTMENT TAX CREDITS

Q 5.1 - Will the Department of Commerce & Insurance treat the allocation of the tax credits as an admitted asset on the insurance company's financial statement?

Yes. The Department of Commerce & Insurance issued a bulletin dated August 7, 2009, confirming this treatment.

Q 5.2 – Will a security (*i.e.*, a bond or promissory note) issued by a TNInvestco to a participating investor in connection with the purchase of investment tax credits be treated as an admitted asset?

Since participating funds may structure their deals with insurance companies separately, they should consult with legal counsel regarding this issue.

Q 5.3 – Prior to the 7th anniversary of the fund, may amounts in excess of the base investment amount be distributed following a liquidity event?

Yes. However, a minimum amount must be maintained equivalent to the base investment amount.

Q 5.4 – Is there a requirement that investment capital be reinvested following a liquidity event?

No. However, the capital may be reinvested during the one-year redeployment period in order to meet the benchmarks set out in 2009 Public Chapter 610, Section 7. In order to comply with the program, the investment levels laid out in Section 7 must be maintained at all times.

Q 5.5 – Will binding commitments to contribute investment capital be sufficient to meet the $14 million base amount at the commencement of the program period?

Yes.

Q 5.6 – While the binding commitment must be made at the commencement of the program period, may the actual contribution be made at a subsequent time?

Yes, provided that the benchmarks set out in 2009 Public Chapter 610, Section 7, are met. This issue potentially impacts federal tax liabilities associated with this transaction. By statute, funds awarded tax credits will work with the state to structure the award of the credit to minimize federal tax obligations.

Q 5.7 – What is meant by the term "cash equivalents"?

"Cash equivalents" is a commonly used financial term that refers to assets that are readily convertible into cash, such as money market holdings, short-term government bonds or Treasury bills, marketable securities, and commercial paper. The Financial Accounting Standards Board defines "cash equivalents" as highly liquid securities with maturities of less than three months.

Q 5.8 – Is there a requirement that designated capital be in the form of equity?

There is no requirement that designated capital be in the form of equity. Rather, a participating investor may invest money in the form of either debt or equity.

Q 5.9 – 2009 Public Chapter 610, Section 3(11)(D), provides that a qualified distribution includes increases or projected increases in certain federal or state taxes of the equity owners of a TNInvestco. How is the amount of a qualified distribution determined in the context of Section 3(11)(D)?

The qualified distribution cannot exceed the actual tax liability due and payable as shown on the investor's actual return. The request for a qualified distribution related to tax liabilities should be made with supporting documentation, including tax returns, verifying the need.

Q 5.10 – 2009 Public Chapter 610, Section 9, provides that "[i]nvestment capital liquidated during a liquidity event will be given a one-year 'redeployment period' for purposes of calculating the investment thresholds in Section 7." What does this provision refer to?

Investments that result in a liquidity event may potentially result in the fund dropping below the investment threshold in any given year. A one-year period is provided to redeploy funds to maintain compliance with program requirements.

Q 5.11 – 2009 Public Chapter 610, Section 3(11), states that a qualified distribution is a distribution or payment not paid to a participating investor, but Subdivision 3(11)(E) states that payments to participating investors *are* treated as qualified distributions. What is the proper interpretation of this section?

Subdivision (3)(11)(E) shall apply, such that a qualified distribution includes any distribution or payment to a participating investor that is in excess of the base investment amount, including any gains from the investment of such base investment amount.

Q 5.12 – Are interest and principal payments to participating investors on debt instruments considered qualified distributions that do not trigger the State Profit Share Percentage as defined in 2009 Public Chapter 610, Section 3(9)?

Distributions qualifying under Section 3(11)(E) are not subject to the State Profit Share Percentage.

Q 5.13 – 2009 Public Chapter 610, Section 7(a)(1)(D)(ii), provides that "any amounts" not invested at the end of the investment period shall be forfeited and paid to the state for use in the Rural Opportunity Fund. Do the words "any amounts" refer to any amounts less than 90% of the base investment amount?

No. As used in this section, "any amounts" refers to any amount less than 100% of the base investment amount. If a TNInvestco elects to not invest the full $14 million of the base investment amount, the entire uninvested amount must be returned to the state prior to profit-sharing distributions to investors.

SECTION 6: GOVERNANCE

Q 6.1 – What level of involvement is required of the Tennessee-based team members?

There is no specific requirement regarding who performs what functions in the investment partnership, however, experience in investing in Tennessee-based companies will be given substantial weight in the decision process.

Q 6.2 – If the TNInvestco fund has more "net proceeds" from the participating investors available to invest than the base amount of $14 million, may any of the surplus be used to cover costs exceeding the statutory maximum for start-up costs and professional service fees?

Yes.

Q 6.3 – May the $500,000 required capital be used to cover costs that exceed the statutory maximum start-up costs of $125,000?

Yes.

Q 6.4 – May the $500,000 be returned to the managers if the TNInvestco has more than $14 million in net proceeds from participating investors?

Yes. However, funds must be available to pay any noncompliance fines or penalties, as these penalties may not be paid for out of tax credit proceeds or gains from investments funded by tax credits.

Q 6.5 – Does the $50,000 professional service fee maximum include individual portfolio deal expenses?

Yes.

Q 6.6 – May a TNInvestco whose affiliates were previously invested (prior to the allocation date) in an otherwise qualified business make new qualified investments in that business out of TNInvestco funds?

Yes, provided that the entity continues to fulfill its fiduciary duty to the program.

Q 6.7 – Will an individual investment manager's residence in Tennessee for at least five years satisfy the requirement that the TNInvestco have its principal office in Tennessee?

The state realizes that the majority of these entities will be newly formed; we will look at the primary place of business of the individuals managing the investment decisions to make this determination. In the alternative, if the manager is a non-Tennessee resident, we will look to see whether he has five years of experience managing investments in Tennessee companies.

Q 6.8 – 2009 Public Chapter 610, Sections 3(11)(A) and (C), include certain costs, expenses, and fees in the definition of "qualified distribution." Do the respective $125,000 and $50,000 caps for organizational expenses and annual professional service fees double in the event that the TN Investco receives two allocations?

Yes. The respective $125,000 and $50,000 caps for organizational expenses and annual professional service fees are per tax credit allocation. Therefore, the caps are doubled in the event a TN Investco receives an allocation of two tax credits.

Q 6.9 – 2009 Public Chapter 610, Sections 3(11)(A) and (C), include certain costs, expenses, and fees in the definition of "qualified distribution." Is the base investment amount reduced by such qualified distributions?

No. The base investment amount is not reduced by qualified distributions. The definition of "base investment amount" states that the term "means fourteen million dollars in the case of a qualified TNInvestco receiving one allocation ... which must be available in cash or cash equivalents immediately following the investment by a TNInvestco's participating investors and its owners." The definition does not provide a deduction from the base investment amount for management fees, professional services fees, and startup costs.

Q 6.10 – Does the early stage multiplier apply in considering the management fee discussed in 2009 Public Chapter 610, Section 3(11)(B)? That is, does the multiplier increase the qualified investment for purposes of calculating the lesser of the TNInvestco's base investment amount or its qualified investments?

No. The definition of "qualified investment" states that "seed or early stage investments shall be increased by three hundred percent (300%) for purposes of determining if a qualified TNInvestco meets the investment thresholds in Section 7." It does not mention using the multiplier for considering the management fee as discussed in Section 3(11)(B).

Q 6.11 – Is a TNInvestco permitted to make an investment in a qualified business using capital that is not designated capital (*i.e.*, using capital received from investors other than participating investors)?

Yes. Note that the TNInvestco may not invest more than fifteen percent of its designated capital in any one qualified business without the approval of the Department of Economic and Community Development. However, there is no similar limitation on the investment of capital received from investors other than participating investors.

Q 6.12 – Is a manager or affiliate of a TNInvestco permitted to be employed by a qualified business in which the TNInvestco makes a qualified investment? If so, are payments to the manager or affiliate by the qualified business treated as qualified distributions?

A manager or affiliate of a TNInvestco is permitted to be employed by a qualified business in which the TNInvestco makes a qualified investment. Remuneration paid by the qualified business to the manager or affiliate is not considered to be a qualified distribution. However, if the TNInvestco compensates the manager or affiliate directly for services rendered to the qualified business, such compensation will be treated as a qualified distribution.

Q 6.13 – If a TNInvestco affiliate performs interim management services for a qualified business, is the qualified business permitted to compensate the affiliate for such services?

Yes. The qualified business is permitted to compensate the affiliate for services rendered, provided that such compensation does not exceed fair market value.

Q 6.14 – 2009 PC 610, Section 10(b), states that "following the seventh anniversary of the fund," investment returns may be distributed as liquidity permits (subject to certain limitations). What date is considered the anniversary of the fund: the allocation date, the date of investment of designated capital, or some other date?

The anniversary of the fund falls on the allocation date. The allocation date is the date on which the investment tax credits were allocated to the participating investor(s).

Q 6.15 – May a qualified TNInvestco make a qualified investment in a company if the TNInvestco had previously invested in the company prior to being selected as a qualified TNInvestco?

Yes, assuming that the company in which the qualified investment is made is a qualified business.

Q 6.16 – May a qualified TNInvestco make a qualified investment in a qualified business, when the managers of the TNInvestco also manage a separate fund that is already invested in the same qualified business?

Yes.

Q 6.17 – May a fund make an investment in a qualified business, when the managers of the fund also manage a TNInvestco that is already invested in the same qualified business?

Yes.